THE FINANCIAL PAGE

IN PRAISE OF INFLATION

In the two years since Lehman Brothers went under, the Federal Reserve has taken extraordinary measures to get the economy moving again. It has bailed out huge financial institutions, slashed interest rates almost to zero, lent hundreds of billions of dollars to American companies, and bought piles of dodgy assets. This pulled us back from the brink of disaster, but, as the fifteen million Americans out of work can testify, it hasn't been enough to get the economy out of neutral. And so a surprising number of high-profile economists, on both the left and the right, think that it's time for the Fed to try one more extraordinary measure: injecting the economy with a healthy dose of inflation.

Odd as that may sound, it's actually not a crackpot concept. Right now, the U.S. economy has two fundamental, and interconnected, problems. First, consumers face huge debt left over from the borrowing spree of the past decade. Second, the dominant sentiment is caution—consumers are hesitant to spend, and businesses are hesitant to expand, invest, and hire. If the Fed were to moderately raise its inflation target—currently around two per cent—and commit itself to keeping prices moving higher for the next couple of years, it could help change this dynamic. If people believe that prices are going to rise in the future, they may be less cautious about spending in the present, since money that isn't put to work will lose value. And, because inflation erodes the real value of debts, people's debt burdens would shrink.

Unfortunately, when the Fed meets this week, it's unlikely to be talking up the merits of an inflation boost. Central bankers are congenitally obsessed with the dangers of inflation and are more concerned with stable prices than with lost jobs. Also, the Fed, by its nature, looks after the interests of lenders, for whom inflation is generally bad news. But there's a more basic reason, too: people really, really hate inflation. In polls, voters regularly cite high prices as one of their biggest concerns, even when inflation is low. A 2001 study that looked at the "macroeconomics of happiness" found that higher inflation put a severe dent in how happy people reported themselves to be. The distaste for inflation is such that a 1996 study (titled, aptly, "Why Do People Dislike Inflation?"), by the Yale economist Robert Shiller, found that, in countries around the world, sizable majorities said that they would prefer low inflation and high unemployment to high inflation and low unemployment, even if that meant that millions of extra people would go without work.

Weimar-style hyperinflation is, of course, an awful thing. But people loathe inflation even in moderate doses, where the evidence suggests it does little damage.

CHRISTOPH NIEMANN

The best estimates of the cost of inflation find that even a ten-per-cent inflation rate—much higher than anyone is currently pushing for—shrinks consumption by just 0.1 to 0.8 per cent. There are other costs, to be sure: inflation shrinks the value of people's savings, and uncertainty about future prices makes business decisions less efficient. There's also the risk of inflation getting out of control. But the historical record suggests that the risk of three-per-cent inflation turning into hyperinflation is very small.

So why is inflation unpopular? The biggest reason, Shiller found, was simply that people believe higher prices reduce their standard of living and make them "poorer." This is obviously true for people living on fixed incomes or off their savings, but for everyone else, as many studies have shown, inflation translates into higher incomes as well as higher prices, and it typically doesn't have much of an effect either way on people's standard of living. (After all, we've had sixty years of inflation in the postwar era, yet we're much more prosperous than we were in 1950.) That's not how it feels, though: myopia leads us to focus on how much more we have to pay, rather than on how much more we earn. Inflation also sets off other alarm bells. It often increases uncertainty, which most people are averse to, and, because it can be described as "weakening" a country's currency, it affects morale. Shiller found that people associated rising inflation with dwindling social cohesion. There's also a moral dimension: we connect inflation to a lack of discipline and failure to live within our means. The most striking thing about Shiller's study was that no one surveyed mentioned any possible benefits of inflation, even though to Americans currently besieged by debts it would be a lifesaver.

This intuitive prejudice against inflation may not be purely rational, but in normal times it's beneficial: it encourages sober habits and discourages quick fixes. But, in times of crisis, other policies may succeed where pure rectitude can't. After the Second World War, when the U.S. was struggling beneath a huge pile of debt, higher inflation helped shrink the real national debt to manageable proportions. And, in times when people are reluctant to take risks, a little inflation can help grease the skids. In doing this, though, inflation helps debtors and spenders at the expense of creditors and savers. It's easy to see why this makes us uncomfortable. It seems to reward those who have behaved recklessly, and to punish those who played by the rules, saving their money and living frugally. But the economy doesn't exist, in the end, to reward virtue and punish vice. It exists to maximize our well-being, and, currently, doing that may require helping the undeserving and irresponsible, if only because there are so many of them. Boosting inflation isn't the *right* policy, but it may just be the correct one.

—*James Surowiecki*